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Volume 2 Selected Papers

Objectives of Financial Statements

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The Risk of Liability for Forecasting*

David R. Herwitz

Summary and Tentative Conclusions

This is a first cut at the question of potential liability for forecasting. It includes a brief look at the common-law background and the current securities law setting, an analysis of the few relevant cases to date, and a little forecasting of its own about possible future developments.

As urged by the Study Group at an earlier meeting, the emphasis is upon the risks that *management* would run in publicly disseminating forecasts, especially if this were to become a regular feature of corporate reporting (whether as a result of pressure from the accounting profession or otherwise). The various possible roles of auditors in the forecasting process, and their corresponding exposure to liability, are left for another day. Further, in order to avoid intruding on the deliberations of the Study Group on the merits, the paper does not attempt to appraise the various pros and cons of forecasting apart from the legal issue, or to delineate the various approaches to forecasting, ranging from the item-by-item projections to one-line estimates of future net income.

On principle it would appear that management would not be liable for a forecast merely because it turned out to be wide of the mark, if it were made in good faith and for a proper purpose, if it represented management's actual belief as to the future prospects, and were prepared with reasonable care and skill; the few cases to date support the conclusion. However, this optimistic prognosis must be tempered with the caveat that, if management forecasts became a regular feature of the reporting scene, at least in the short run there might well be a significant increase in the *risk of being sued,* as distinguished from the risk of liability, because forecasts that go awry will present a very inviting target to potential shareholder litigants. Hopefully,

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* This paper was submitted as a memorandum to the Study Group on the Objectives of Financial Statements on June 23, 1972. Its style remains unchanged for this printing. See footnote 1, p. 248, which reflects SEC action on forecasting during 1973.

judicial pronouncements would soon make the game not worth the candle when nothing more than erroneous projection is involved.

There is little reason to doubt that most managements could and would routinely meet the tests of good faith, proper purpose, and honest belief; but carelessness is a fact of life, and hence the real nub of this issue may be the extent of liability when there is a failure of due care in the preparation of the forecast. It is an open question whether, under general legal principles, negligence in the preparation of a forecast otherwise made in good faith in the normal course of management's reporting function should or would give rise to liability to the entire universe of existing shareholders and prospective investors for losses allegedly resulting therefrom. This question is equally unsettled under the securities law provisions, like Rule 10b-5, which are addressed in general terms to fraud or deception and accordingly would seem to require something akin to intentional or at least knowing misrepresentation, rather than mere negligence, at least in a civil action for damages rather than a suit for rescission or an SEC injunction action. Resolution of this question will have to await further clarification by the courts. Section 11 of the Securities Act, dealing with registration of stock for sale to the public, stands on a special footing since the statute appears to expressly require due care and to lay particular onus on anyone cast in the role of an expert, as might be true in the case of a forecast if it were prepared or "certified" by an analyst or, perhaps, an accountant; but, at the moment, the SEC does not permit forecasts or projections in a prospectus under Section 11 anyway.[1]

Common-Law Background

The law relating to liability for providing inaccurate or insufficient information in the securities field has, of course, been largely taken over by the federal securities legislation. Nevertheless, in seeking to appraise the risks of liability associated with a relatively new phenomenon like forecasting, a quick look at the applicable common-law principles is a good starting point.

Under the common law of torts, a distinction has always been drawn between statements of opinion and statements of objective fact, so far as liability for error is concerned. The basis for this distinction is that in the

[1] Since the date when this paper was prepared, the SEC has revised its policy on forecasts, with the promulgation, after extensive public hearings, of Sec. Exch. Act Rel. No. 9984 (Feb. 2, 1973). Under this Release, the Commission would allow, though not require, issuers who are reporting companies and who meet certain standards relating to earnings and budgeting experience to include projections in various filings with the Commission. The Release also announces that the Commission will promulgate rules relating to the liability provisions of the securities laws, to define the circumstances under which a projection would not be considered to be a misleading statement of a material fact. In this connection, the Release contains the following observations (which seem to be in accord with the main thrust of this paper): "It is contemplated that [the new rules] would embody the concept that a projection is not a promise that it will be achieved nor per se misleading if not achieved. A projection would not be considered to be a misstatement of a material fact if it were reasonably based in fact, prepared with reasonable care and carefully reviewed."

classic "one on one" bargaining situation that the common law normally contemplated, a reasonable person would not, or at least should not, rely upon the opinion of his adversary since such an opinion could be expected to be self-serving, and even exaggerated, within fairly wide limits. This view is embodied in the so-called "puffing" doctrine, under which a seller is allowed broad latitude to commend his own wares in an effort to persuade another to buy.

However, most of the recent authorities, particularly in the securities field, have tended toward narrowing the permissible scope of opinions. For one thing, the courts have become quicker to parse statements of intermingled fact and opinion to find one or more misrepresentations of fact. In addition, there has been greater recognition that even a pure statement of opinion involves at least one implied representation of fact, that is, that the speaker actually holds the opinion expressed. Between two parties with fully equal bargaining power, this may be an immaterial fact, with no liability for misrepresentation of it. But where one party has greater knowledge or expertise than the other (as is commonly true in securities transactions), reliance may be justifiable; in such cases the implied representation that the opinion is honestly entertained may also carry with it the implied assertion that there is some reasonable basis in fact for the view expressed. Courts have become more willing to find justifiable reliance on these implied representations of fact embodied in an expression of opinion, especially where the complaining party only seeks rescission of the transaction to get back to where he started, rather than damages for deceit, which would normally entitle him to recover an amount measured by what the transaction would have been worth to him if it had been as described.

Where do forecasts fit into this framework? While such a prediction as to future events does amount to merely a statement of opinion, a forecast may well include an implied representation that it represents the forecaster's honest belief about the future and that there is some reasonable factual basis for that belief, especially if the forecast is promulgated by the management (or anyone else with special access to information). Meeting this standard would presumably require at least that the forecast be based upon a reasonable analysis of the available data, and perhaps also that it reflects the product of such professional competence as those who publicize it appear to possess.

On the other hand, where a forecast (or other prediction) is made in good faith for proper purposes, actually represents the forecaster's best estimate, and is prepared with reasonable care, there should not be any common law liability merely because the results turn out to be quite different from those forecast. After all, one who makes a forecast does not thereby undertake to warrant the future; hence, there would be no breach of duty upon which liability could be predicated.

There seems little reason to doubt that, in the main, managements could and would meet these standards of good faith, proper purpose, actual belief in the estimate, and reasonable care in preparing it. Nevertheless, the reasonable care requirement must give us some pause, since experience teaches that "to err is human," and with any increase in activity comes an increase

in negligence, even with the best of will; hence, it would be foolhardy not to expect some careless projections, if forecasting becomes far more widespread. Moreover, it is predictable that there would be a heavier concentration of alleged and actual carelessness during the early period of any transition to widespread forecasting, while managements are getting used to what for many will be a new activity (although perhaps this would be offset by the courts' adopting a somewhat lower standard of reasonable care at the outset, which could be raised as the state of the forecasting art develops). This ties in with the point made earlier, in the summary, that a considerable proliferation of lawsuits relating to forecasts must be expected when and if they become a regular feature of corporate reporting, just because they will present such an inviting target. The combination of these two factors suggests an inevitable and uncomfortable chorus of "I told you so," at least in the short run, from opponents of forecasts if their opposition is overridden, a point of some force though obviously not conclusive.

In any event, on the merits it is not entirely clear to what extent there would be liability for a forecast which turned out to be erroneous because of carelessness in preparation. The question of liability for negligent but unintentional misrepresentation has been one of the most troublesome in the law of torts; and here we are not even dealing with a direct factual misrepresentation, but only a failure in the implied representation that a forecast is the product of reasonable care. The courts have long been wary of imposing liability for pecuniary loss from misrepresentations that are merely negligent because, unlike the case of physical injury, which is generally at least somewhat localized, misinformation may be so widely disseminated and circulated that the resulting losses could be virtually unlimited, thus creating the prospect of "a liability in an indeterminate amount for an indeterminate time to an indeterminate class." *Ultramares Corp.* v. *Touche, Niven & Co.,* 255 N.Y. 170, 174 N.E. 441 (1931). The result could be a crushing burden of liability, out of all proportion to the magnitude of the defendant's fault where he has done no more than fail to use reasonable care.

The best-known cases of this kind are, of course, those (like *Ultramares*) involving the liability of accountants for negligence to parties other than the particular client for whom erroneous financial statements were prepared or certified. Of late there has been a marked tendency away from the so-called "privity" doctrine, under which an accountant's liability for negligence (apart from securities law provisions) was pretty much confined to his client or other person with or for whom he had specifically dealt, and in the direction of making the accountant liable at least to "limited classes of persons" whose likely reliance on the statements involved could be readily foreseen. See *Rusch Factors, Inc.* v. *Levin,* 284 F. Supp. 85 (D.R.I. 1968) (holding an accountant liable to a prospective lender who had been specifically identified as one to whom the statements would be shown). The latest version of the Restatement of Torts (Second) has taken the lead in this development, with the following provision in section 552 (Tent. Draft No. 12, 1966):

(1) One who, in the course of his business, profession or em-

ployment, or in a transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

(2) Except as stated in subsection (3), the liability stated in subsection (1) is limited to loss suffered (a) by the person or one of the persons for whose benefit and guidance he intends to supply the information, or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction which he intends the information to influence, or knows that the recipient so intends, or in a substantially similar transaction.

(3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them.

Though its primary role to date has been to help extend the liability of accountants, Restatement section 552 is certainly not confined to such cases but applies to negligent misrepresentations by anyone. Hence negligent misrepresentations by corporate officers, in the course of forecasting or otherwise, would fall within its ambit; and, of course, forecasting is an excellent example of a situation where the defendants could face liability to untold numbers of investors for untold amounts of market losses allegedly resulting from a careless mistake in the forecast. Since it is quite likely that, just as they have recently in the case of accountants' liability, the common-law courts would look to this Restatement provision for guidance in setting limits on the liability of management for negligent forecasts, we should do the same; but unfortunately section 552 provides no ready answer. One of the *Reporter's* comments to section 552 makes it clear that the beginning phrase is not intended to confine the section to statements made in the course of a professional engagement: "Thus the officers of a corporation, although they receive no personal consideration for giving information concerning its affairs, may have a pecuniary interest in its transactions since they stand to profit indirectly from them." Moreover, the words "the persons for whose benefit and guidance he intends to supply the information" in paragraph 2 (a) of the section certainly could encompass the entire investing public in the case of a forecast disseminated by management for the general information of the investing community. On the other hand, it seems clear that section 552 is intended to confine the scope of potential liability to something less than all of those who might foreseeably rely upon the statements made. Precisely the same question arises, of course, with regard to accountants: Will they be liable for negligence under section 552 to all of the stockholders of the company (and perhaps also prospective investors) on the ground that they are the primary intended beneficiaries of the accountant's engagement? On this question we do not have any judicial intimations as yet, but some light is

shed by the *Reporter's* illustrative examples under section 552, which seem to indicate an intention to confine liability to a more limited class of persons:

Illustrations

* * * * *

2. *A* is negotiating with the *X* Bank for a credit of $50,000. The Bank requires an audit by certified public accountants. *A* employs *B & Company,* a firm of accountants, to make the audit, telling them that it is to meet the requirements of the *X* Bank. *B & Company* agree to make the audit, with the express understanding that it is for transmission to *X* Bank only. The *X* Bank fails, and *A* without any further communication with *B & Company* submits their certification to the *Y* Bank, which in reliance upon it extends a credit of $50,000 to *A*. The audit is so carelessly made as to greatly overstate the financial resources of *A,* and in consequence the *Y* Bank suffers pecuniary loss through its extension of credit. *B & Company* is not liable to *Y* Bank.

3. The same facts as in Illustration 2, except that nothing is said about supplying the information for the guidance of *X* Bank only, and *A* merely informs *B* that he expects to negotiate a bank loan, and has the *X* Bank in mind. *B & Company* is subject to liability to *Y* Bank.

4. The same facts as in Illustration 2, except that *A* informs *B* that he expects to negotiate a bank loan, but does not mention the name of any bank. *B & Company* is subject to liability to *Y* Bank.

* * * * *

7. *A,* a certified public accountant, is employed by *B* Company to prepare and certify a balance sheet for the corporation. *A* is not informed of any intended use of the balance sheet, but *A* knows that such certificates are customarily used in a wide variety of financial transactions with the corporation, and that it may be relied upon by lenders, investors, shareholders, creditors, purchasers, and the like, in numerous possible kinds of transactions. In fact *B* Company uses the certified balance sheet to obtain a loan from *X* Bank. Because of *A's* negligence the balance sheet presents an inaccurate picture of the finances of *B* Company, and through reliance upon it *X* Bank suffers pecuniary loss. *A* is not liable to *X* Bank.

It would seem that the limitation implied in these examples should be equally applicable in the case of management forecasting (and maybe even more applicable, since forecasting would constitute only a minor aspect of management's activities, rather than the primary product of a professional engagement for a fee, as in the accountant's case). However, an eye must be kept on paragraph 3 of section 552, since management forecasting might arguably become a "public duty" if it came to be required, for example, by the SEC.

Thus, the most that can be said about liability for negligent forecasts at the moment is that the matter is very much in flux, as part of the general uncertainty relating to negligent misstatements. It should also be kept in mind

that even if there are limitations on liability operative in the case of "mere" negligence, they may be lost in the event of gross carelessness, such as a substantial failure to do the spadework necessary to form a meaningful opinion, which could be characterized as constructive fraud rather than simply negligence. See, e.g., *State Street Trust Co.* v. *Ernst,* 278 N. Y. 104, 15 N.E. 2d 416 (1938). For the sake of completeness, it might be added that there could, of course, be difficult questions in attempting to measure the amount of loss "caused" by a negligent forecast, as, for example, where a carelessly over-optimistic forecast is followed by sharp drop in stock prices in conjunction with an overall market slump. But causation represents a story all its own, which we need not pause to consider since forecasting would not appear to present any special problem in this area.

The Impact of the Securities Laws

Of course, suits concerning forecasts, like everything else in the securities field these days, will in fact be lodged not under the common law but rather under one or more provisions of the federal securities laws. There is no need for a detailed catalogue of these various provisions at this point; suffice it to note that except for Section 11 of the Securities Act, which affirmatively requires accurate information in connection with registration of securities for sale to the public, subject to a defense of reasonable care for everyone but the issuer, all of the securities law provisions amount to some variant of a prohibition against fraudulent or deceptive conduct. The prime example is the famous (or infamous) SEC Rule 10b-5, promulgated by the Commission pursuant to § 10 (b) of the Securities Exchange Act of 1934, which prohibits the use of "any manipulative or deceptive device or contrivance" in contravention of rules prescribed by the SEC. For convenient reference, here is the relevant language of Rule 10b-5, making it unlawful, in connection with the purchase or sale of any security:

> (1) to employ any device, scheme or artifice to defraud, (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

Where do forecasts and other predictions stand under such securities law provisions? The starting point, at least, is the same as under the common-law analysis above. Most of the cases in point, to date, have involved over-optimistic predictions by securities salesmen as to the likely future price of a stock (not infrequently interspersed with observations about likely future sales, net income, and the like); and while the courts have recognized the distinction between "mere predictions and opinions" and representations of fact, they have been quick to find a knowing factual misrepresentation when there was no reasonable basis for the opinion expressed, e.g., *SEC* v. *F. S. Johns & Co.,* 207 F. Supp. 566 (D.C.N.J. 1962) ("Nor may refuge be sought in the argument that representations made to induce a sale of stock dealt merely

with forecasts of future events relating to projected earnings and the value of the securities, except to the extent that there is a rational basis from existing facts upon which such forecast can be made, and a fair disclosure of the material facts."); *SEC* v. *Broadwell Securities, Inc.,* 240 F. Supp. 962 (S.D.N.Y. 1965) ("Mere predictions and opinions" unlawful under Rule 10b-5 where "the salesmen knew, or should have known, that there was no basis in fact for such optimistic representations."); *Irwin* v. *United States,* 338 F2d 770 (9th Cir. 1964) (Even if forecasts of future profits were merely opinion, "implicit in any such expression of opinion . . . is the representation of fact that such opinion is honestly entertained," which requires a showing of some basis in fact.). The emphasis on a "reasonable basis in fact" which recurs in the foregoing cases is merely a variant on one of the common-law themes referred to above; and, of course, such a standard should not pose any threat to a management properly doing its job in the forecasting area.

What about liability for negligent misrepresentation under Rule 10b-5? The answer is as uncertain here as under the common law, although for somewhat different reasons. Because the roots of Rule 10b-5 lie in a statutory prohibition against fraud and deception, concepts which have always imported the element of intentional, or at least knowing, misrepresentation (or perhaps reckless disregard of whether the statement is true or false)—the so-called "scienter" requirement—there is much force in the contention that negligence alone cannot constitute a violation of the Rule. The majority of the judicial comments on the Rule are consistent with this view, so far as private suits for damages are concerned, although it appears to be generally agreed that negligent conduct may be enjoined. On the other hand, many of the commentators have favored a right of action for negligence, subject to varying limitations, and there are few decisions which hold or assume that negligent misrepresentations are actionable under the Rule, e.g., *Drake* v. *Thor Power Tool Co.,* 282 F. Supp. 94 (N.D. Ill. 1967). (Allegations of erroneous financial statements against a company and its accountants by an open-market purchaser of stock can "be sustained as either an intentional misrepresentation or as a negligent misrepresentation.")

As to the old common-law requirement of privity, and the current version of that limitation embodied in Restatement Section 552, there has been little discussion in the Rule 10b-5 cases involving negligence. To be sure, the *Drake* case, cited above, does state expressly that "notions of privity cannot apply" in actions under Rule 10b-5, because that would impede the objective of the Rule to protect investors and the public interest, and a number of the commentators reach the same conclusion. Unfortunately, however, the *Drake* court relies primarily on cases involving alleged intentional or knowing misrepresentation, where there has always been a good deal less disposition to limit a defendant's liability. In any event, there is certainly no basis for optimism that, if there is liability for negligence under Rule 10b-5 at all, it will be limited in a manner akin to Restatement Section 552 or otherwise.

As noted in connection with the common-law analysis, there will be troublesome questions of causation in connection with liability for forecasting, and that is no less true under Rule 10b-5. While this question need not

be labored now, the comments of a leading Rule 10b-5 authority, Bromberg, are worth noting:

> Causation is much the trickiest of 10b-5 elements to evaluate, both in terms of what the law is (since so few cases have reached the stage of dealing with the questions), and in terms of what it should be (especially in open market cases, because of the complex of factors which may join in causing losses and the large number of persons who may be affected). To dispense with it entirely would expose issuers, insiders, and perhaps others to immense liabilities for relatively minor misconduct. To insist that it be strictly proved would immunize them from civil liability in most instances, regardless of how major their misconduct. Some middle ground needs to be found, perhaps differing from case to case.[2]

The Relevant Cases to Date

(a) There have been thus far some four cases which are sufficiently relevant to the legality of management forecasts to call for analysis here. The most straightforward of them, and hence the best starting point, is *Milberg* v. *Western Pacific Railroad Co.*, 51 F.R.D. 280 (S.D.N.Y. 1970). There, a stockholder of Western Pacific brought an action under Rule 10b-5 against Western Pacific, together with Dow Jones, as publisher of *Barron's,* on account of an article about Western Pacific which appeared in the May 19, 1969 issue of *Barron's* and contained the following: "Western Pacific got off to a slow start this year. . . . Net for the June quarter, however, is expected to show some improvement over the $1.7 million, or 84 cents per share, earned in the like three months of 1968." Earnings for the June quarter turned out to be only 25 cents per share.

The plaintiff purchased 65 shares of Western Pacific common on June 12, 1969, at a cost of $35⅜ per share. She made no claim of having read the article in question, but maintained that her purchase was influenced by the general market climate created by that article. Subsequent to her purchase, the market price of the stock dropped considerably, and the plaintiff sought to recover for her market losses, claiming that *Barron's,* or Western Pacific if it had supplied the information in the statement, had acted with "careless, reckless, and wanton disregard as to truth or falsity."

The specific issue at this stage of the proceedings arose out of plaintiff's efforts to bring the suit as a class action, under Rule 23 of the Federal Rules of Civil Procedure, on behalf of all persons who bought common stock of Western Pacific between May 19 and July 31, 1969. As such a class action, the amount of the potential recovery could be quite large (assuming, of course, there was any recovery at all), which would mean a contingent fee of sufficient potential to induce counsel to pursue the suit; an individual plaintiff would often not have enough at stake to justify the expense of such a litigation. While of course a decision on whether to allow the suit to proceed as a class action is not the same as a decision on the merits, there is a close

[2] Bromberg, *Securities Law: Fraud* (1967), p. 220.

relationship between the two, because one of the tests imposed by the courts for qualification as a class action under Rule 23 is whether the plaintiff can make a preliminary showing that there is a substantial possibility of success on the merits. Applying this test, the court found that the plaintiff had little chance of succeeding in this case and hence refused to permit a class action. The court's observations on the merits of the plaintiff's claim are illuminating:

> What plaintiff is apparently attempting to do by this action is establish a new rule of law to the effect that, when a financial publication prints an estimate of a company's earnings, the company must earn at least that amount or both the publication and the company will be held strictly liable for any loss in market value of the stock after the date when the estimate is printed. This would be a most unusual rule of law to say the least, but it is the only framework within which the plaintiff can claim a cause of action.

It should be observed that the case is not squarely in point with regard to management forecasts since the court noted that *Barron's* did not purport to quote Western Pacific. (The court added that imposing liability on Western Pacific in such a case would mean that a corporation would have to read every article written about it to detect and disavow any inaccuracies.) But the court's comments with regard to Dow Jones would seem equally applicable to management forecasts made in good faith. After noting that no proof had been offered to show that Dow Jones deliberately or recklessly mistook the facts, the court added that "the estimate of earnings was no more than an estimate and could not reasonably have been expected to be infallible." The court characterized the plaintiff's effort as one of seeking "strict liability," that is, absolute liability for any error, which the court clearly seemed to regard as inappropriate. (The plaintiff's appeal from the denial of a class action was dismissed by the Court of Appeals for the Second Circuit, on the procedural ground that such an appeal will not lie unless a class action is essential to a continuation of the suit, and here the plaintiff's loss, together with that of her husband, the attorney in this case, was large enough to justify their continuing the action on their own.)

(b) The major case to date on forecasts is *Dolgow* v. *Anderson,* 53 F.R.D. 664 (E.D.N.Y. 1971), involving an action by stockholders of Monsanto Chemical, under various securities law provisions including Rule 10b-5, against the company and some of its directors and officers. The alleged ground for the suit was that, in order to sell some of their own holdings at higher prices, the individual defendants had manipulated the price of Monsanto stock by publishing false and misleading forecasts of earnings while concealing inside information that would have indicated a likely decline in earnings. The plaintiffs sought damages for the losses they suffered as a result of their purchases of Monsanto stock during the period of alleged artificially high prices.

The facts relating to the forecasts require some detail. Monsanto's net sales and net income for the four-year period 1961-1964 had grown rapidly, and 1964 was a record year, with net sales of nearly $1.4 billion and net

earnings of approximately $115 million, or $3.72 per share. At the end of 1964, in the normal course of its program of periodic presentations to, and interviews with, financial analysts and commentators, Monsanto projected that 1965 results would surpass 1964. At the end of each of the first three quarters of 1965, with record results being logged in each one, Monsanto projected increased sales and earnings for the year as a whole. During the fourth quarter of 1965, Monsanto experienced some temporary start-up difficulties in plants using new processes, but despite these problems net sales and net income both set all-time highs in 1965, with sales rising to $1.5 billion and net income to $123 million, or $3.89 per share.

At the end of 1965 Monsanto anticipated that the operations in 1966 would show an increase over 1965's record results. In the first half of 1966 sales and income did continue to climb, setting new records for any six-month period, and Monsanto continued to estimate that overall 1966 results would exceed those of 1965. However, during the second half of 1966 the chemical industry in general, and large synthetic fiber producers like Monsanto and Dupont in particular, were especially hard hit in a general business and stock market recession. Synthetic producers experienced a number of severe and unanticipated setbacks, such as the austerity program in Great Britain which curtailed consumer spending, sharp reductions in the prices of nylon and polyester, and a fall-off in the consumption of acrylic fibers in the United States caused by the lack of housing starts and tight money.

As a result of these unanticipated difficulties, even though Monsanto's 1966 sales were some 10 per cent higher than in 1965 its income for the year declined to just over $112 million. (At the same time Dupont, which also had expected its 1966 earnings to increase, suffered a decline in net income from operations during the third and fourth quarters of 1966, and its overall net income for 1966 was less than that of 1965.)

During 1966 market prices of securities generally declined, with the Dow dropping more than 200 points from 955 on February 9 to 744 on October 7. The decline among the chemicals was even greater, and during the last half of 1966 the prices of Monsanto and Dupont stock declined more than those of the overall chemical industry. One of the plaintiffs (the only one whose own claimed loss was more than nominal) had bought 300 shares of Monsanto in April 1965, and sold them in October 1966, at a loss of more than $14,000.

The primary issue before the court in this case, as in the *Milberg* case, was whether the plaintiffs had shown a sufficient possibility of prevailing on the merits to entitle them to bring the suit as a class action. However, the procedural setting was a good deal more complicated than in *Milberg,* and requires some explanation for a full appreciation of the significance of the decision. In a prior opinion (which incidentally tells you all you ever wanted to know about class actions in the securities field—and then some!), the court had decided that the plaintiffs' likelihood of success (and consequent right to a class action) should be determined by holding a preliminary hearing at which the plaintiffs would have to show (1) that there was a material discrepancy between the defendants' predictions as to Monsanto's future pros-

pects and what actually occurred, and (2) after submission of evidence by the defendants as to their transactions in Monsanto stock during the period in question and the internal corporate memoranda containing the information on which they relied in making their predictions, that there was a "suspicious" pattern of securities transactions by the defendants during the period in question, and that, on the basis of information before them, the estimates by the individual defendants were not reasonable. 43 F.R.D. 472 (1968).

After a lengthy hearing, the trial court not only disallowed a class action but also entered a summary judgment *on the merits* for the defendants, based upon the finding that there was no evidence to support the plaintiffs' charges. The Court of Appeals reversed, holding that the trial court should not have granted summary judgment on the merits for the defendants; in addition, apparently fearing that the class action issue might have been observed by the erroneous summary judgment decision, the Court of Appeals ordered a reconsideration of the class action question also. 438 F. 2d 825 (2d Cir. 1970), 438 F. 2d 833 (1971). (On rehearing, the Court of Appeals softened its decision to a remand of the case to the trial court for the purpose of making express findings of fact and conclusions of law, which the trial court had not done. 438 F. 2d 833 (1971).)

It was in this rather complex procedural framework that the matter finally came on for decision in the instant case (and the procedural background has been set out in this almost dizzying detail because it does focus sharply the difference between allowing a class action and a decision on the merits, a distinction which is likely to continue to loom large in securities law litigations). The trial court reaffirmed its refusal to allow a class action, reiterating its finding that there was no substantial possibility of the plaintiffs succeeding on the merits, but also emphasizing its conclusion that the individual plaintiffs had enough at stake in the suit, particularly in the light of their claims for substantial punitive damages, to make it likely that the case would go forward even though it was not a class action. (The court expressly reserved judgment on whether its decision on the class action issue would have been the same if its conclusion had been different as to the amount at stake.)

With regard to the forecasts, the court explicitly rejected the plaintiffs' claim that the internal data of Monsanto did not justify the issuance of forecasts of substantial earnings gains during the 1964-66 period. Rather, the court held, the "information available to defendants as shown by the material submitted to the court and available through extensive discovery indicates that those forecasts were sound when made and that the subsequent failure of earnings to meet predictions was due to market and other changes that a reasonable businessman would not have foreseen or would have discounted in making predictions."

In addition, the court commented favorably upon Monsanto's program of public disclosure, which included its annual and quarterly reports, periodic distribution of press releases containing information regarding Monsanto developments, and various presentations to, and interviews with, financial analysts, members of the press, and shareholders to report on the current

situation at Monsanto and to indicate prospects for the future. The court observed that the temporary plant start-up difficulties which Monsanto experienced in the fourth quarter of 1965 had been reported in public statements which appeared in various financial news media. In addition, during the last quarter of 1966, when Monsanto, as well as the entire fiber industry, was experiencing severe and unanticipated set-backs, there were numerous public statements reporting these difficulties in the news media. The court concluded that Monsanto's program of public reporting was appropriately calculated to inform its stockholders, the financial community, and the public generally, in a fair, current, and timely manner, of the company's results, prospects, and current developments and problems, including any changes in prospects and problems, without disclosing confidential information that might have been of greater interest to competitors than investors.

In connection with examining the correlation between the public projections by the individual defendants and the internal Monsanto information, the court undertook a lengthy analysis of the company's internal budgeting operations (which are worth reviewing because if they are not now commonplace they may well become so after having received judicial approval in this case). The basic internal documents consisted of "Corporate Long-Range Plans," yearly "Budgets," quarterly "Budget Reviews," and so-called "Capital Appropriation Requests." The Corporate Long-Range Plan, which covered a period of five years and was revised annually, was the product of input from every level of the company, from the salesmen in the field all the way to the general managers of the various Monsanto divisions. In addition to this long-range plan, each year in the fall every division of Monsanto prepared a budget for the next year, indicating among other operating data the budgeted sales and earnings for the division. These divisional budgets were extensively reviewed by budget committees at various levels, and then consolidated into an overall corporate budget which was presented to the Board of Directors for approval. This work involved the effort and judgment of many people in each division who assembled cost and price data: The marketing people estimated the number of pounds of each product which might be sold at various prices based on discussions with customers; the manufacturing people calculated the cost of manufacturing these products; accounting personnel assessed overhead, research and other charges. The quarterly "Budget Review" was regularly prepared at the end of the first and second quarters of each year and included forecasts of sales and earnings as of that time for the balance of the year.

The court made an express finding that these internal records were appropriately prepared and extensively reviewed for the purpose of fairly and realistically reflecting Monsanto's results and the estimates of its future prospects. The court also found that the Monsanto management insisted that these internal documents and estimates be as honest and accurate as possible, and that as a result these internal projections were reasonable and actually represented the best estimates of the future by the Monsanto people most qualified to make such estimates.

The court then concluded with its ultimate findings that (1) all of the

statements and forecasts complained of by the plaintiffs were consistent with, and fairly and accurately reflected, the information in the internal documents; (2) the public statements and forecasts were intended to accomplish the proper objective of informing Monsanto's stockholders and the public of the results of operations and other matters of interest concerning Monsanto; and (3) Monsanto's results, prospects, developments, and problems were fairly and timely reported to its stockholders and to the public. (Of less relevance to us are the court's other two conclusions: First, that the sales of Monsanto stock by the individual defendants during the period in question were mostly for the purpose of raising funds with which to exercise Monsanto stock options, so that on balance the defendants were buyers during this period rather than sellers and second, that the transactions of the individual defendants were undertaken in good faith, and based on the same information as had been made available to outsiders.)

The opinion concludes with some rather sympathetic observations about the impact of lawsuits, especially class actions, on managements in cases like this. The court noted that if cases as doubtful as the instant one were allowed to continue as class actions, it would encourage and prolong such litigation, subjecting many corporate managers to the considerable financial burden of defending, which the court thought might prove particularly difficult for men who had risen recently in the corporate hierarchy and hence might have relatively limited financial resources. In addition, the court commented that, especially these days when corporate executives are encouraged to publish information and to open their doors to analysts, a rule of law that was too restrictive and inflexible (presumably meaning a rule that could give rise to liability merely because predictions do not come true) might tend to over-inhibit managers without providing any gain to investors in the form of more reliable predictions. The court added, apparently in response to a contention by the plaintiffs that the Monsanto management should have been more alert to the potential down-turn in the company's affairs in 1966, and in any event with evident admiration, that among the attributes of the successful executive are his enthusiasm and his "conviction" that any business problem he may encounter can be solved.

Having decided that the suit could not go forward as a class action, about a week later the trial court reinstated its grant of summary judgment *on the merits* to the defendants. Since the Court of Appeals had already indicated grave doubt about the propriety of this step, we may well not have heard the end of this case.

It is worth pausing to consider some of the implications of the *Dolgow* decision (which, unlike *Milberg,* is unequivocably a management forecast case). First, note that the plaintiffs did not simply charge the defendants with making a forecast which turned out to be erroneous. (This was equally true in *Milberg,* where the plaintiffs alleged "careless, reckless, and wanton disregard as to truth or falsity," but the court found no evidence of deliberate or reckless mistake, and made it clear that mere error in the forecast would not give rise to liability.) The plaintiffs' allegations were much more serious, that is, that the forecasts promulgated by the defendants were inconsistent

with the internal data, and that the defendants were thereby seeking to feather their own nests. Of course a claim that corporate officers and directors were acting in their own self-interest rather than for the benefit of the corporation amounts to a charge akin to fraud under any standard. Of much greater interest to us in this inquiry is the claim that the published forecasts were inconsistent with the available internal evidence, since that would appear to spell out a classic case of misrepresentation in connection with an opinion. That is, the publication of the forecasts by the defendants carried with them the implied representation that the defendants actually held the opinions expressed and had a reasonable basis for those opinions, and one or the other of those representations, or perhaps both, would be false if the defendants were in possession of reliable data inconsistent with the forecasts made.

Of course this question became moot in *Dolgow* with the court's finding that there was in fact no inconsistency between the published forecasts and the internal records (along with the finding that the defendants were not seeking to favor their private interests in the market, which was the only motive advanced by the plaintiffs for the alleged departure of the published forecasts from the internal data). But the court's painstaking comparison of the published forecasts with the in-house figures stands as a strong warning of the danger of departing from the internal data, which would have serious implications for any management preferring to use for publication figures more conservative than its internal projections, either out of desire to publicize a more readily reachable goal or because the internal budget figures themselves were more in the nature of a target than a realistic projection of future results.

Also of some significance is the court's detailed analysis of the company's internal budgetary procedures, leading to the conclusion that the internal figures were the product of thoughtful and conscientious efforts by the people in the company best qualified to do this work. It would appear that the court thought it relevant to demonstrate the absence of negligence in preparing the internal data which formed the basis of the published forecasts, thus perhaps implying that there could indeed have been liability merely for negligence (for example, if the internal work, in which most of the defendants had presumably participated, had been careless or inadequate). However, we are left entirely to inference with regard to possible liability for negligence, since the opinion does not deal specifically with the issue, either in the foregoing context or in connection with the plaintiffs' claim, referred to in one of the earlier opinions in the case, that the defendants should have foreseen a decline in Monsanto's earnings for 1966 because of the expiration of certain license rights that year, which sounds like an express charge of negligence.

(c) Less directly in point but still instructive is the case of *Butler Aviation International, Inc.* v. *Comprehensive Designers, Inc.*, 307 F. Supp. 910 (S.D.N.Y. 1969), affirmed, 425 F. 2d 842 (2d Cir. 1970). Butler Aviation sought a preliminary injunction against CDI's tender offer for Butler shares on the ground that CDI had artificially inflated the market price of its stock by

making misleading projections of future earnings and later misrepresenting past earnings. At CDI's annual meeting in September 1968, the president of the company had predicted (with what he claimed were "numerous hedges") earnings for the last quarter of fiscal 1969 (ending April 30, 1969) of nearly 20 cents per share and earnings for the year of about 60 cents per share. This prediction was repeated without any qualifications in a press release shortly thereafter and was somewhat reinforced by another press release in December 1968, which reported second-quarter earnings and said they bolstered the company's "confidence in previously projected improvements" during the balance of the year. Earnings for fiscal 1969 actually turned out to be only 33 cents per share, compared with 52 cents for fiscal 1968. In addition, earnings for the last quarter of fiscal 1969 would have been lower than those of the third quarter, but for a change in the method of accounting for year-end adjustments (allocating them among all four quarters instead of entirely to the last quarter, as in the past), which was adopted for the purpose of making sure that fourth-quarter earnings were at least a little higher than third-quarter earnings. Nevertheless, CDI's annual report referred to an improvement in earnings for the fourth quarter over the third quarter, without any disclosure of the change in accounting practice.

The trial court allowed the preliminary injunction because of the great likelihood that the plaintiff would ultimately succeed in establishing misrepresentations under Rule 10b-5 [as well as section 14(e) of the Securities Exchange Act, regulating tender offers] in connection with the unqualified earnings projection for fiscal 1969, and the bald statement that fourth-quarter earnings for fiscal 1969 had exceeded those of the third quarter. In affirming, the Court of Appeals agreed that CDI deserved censure but was more doubtful as to the effect of these "delinquencies" on the exchange offer for Butler stock, since that did not come until November 1969 and was pursuant to a full prospectus on file with the SEC which was not alleged to contain any misrepresentations. The Court of Appeals noted that the price of CDI stock had actually fallen from $18 at the time of earnings projections in September 1968 to $15 in November, although it then rose steadily to $35 in May 1969. Moreover, the Court thought that all of the forecast damage would have been dissipated by the issuance of the Annual Report for fiscal 1969 on August 20, showing the actual earnings of only 33 cents per share for the year. The Court was more troubled by the statement about improved fourth-quarter earnings, but noted that this had not been repeated in the tender offer prospectus. However, the Court of Appeals decided that a company intent on an acquisition program should be especially careful to guard against misstatements and so, with some reluctance, affirmed the trial court's decision.

This case is clearly not primarily concerned with inaccurate forecasts, in view of the presence of the factual misrepresentation as to fourth-quarter results, which alone would have justified the decision. But the case is certainly not inconsistent with the notion advanced herein that a management forecast is not a warranty of the future, although to be sure the court never says this expressly. There was sufficient reason to condemn the forecast in this case that it was allowed to be disseminated without the qualifications

the president concededly thought were called for, with the result that the forecast implied greater assurance than the forecaster actually felt (to say nothing of whether the forecast had been prepared with reasonable care, as to which the court had no occasion to comment at this preliminary stage in the proceedings). A forecast in unqualified terms here, in other words, was a misrepresentation of the actual state of mind of the person making the forecast, and that does amount, as we have seen, to a misrepresentation of fact.

(d) The last of the cases worth noting is *Sprayregen* v. *Livingston Oil Co.*, 295 F. Supp. 1376 (S.D.N.Y. 1968), which involves a suit under Rule 10b-5 and the common law against three directors of a company, its accountants, and its public relations firm for losses allegedly suffered in buying (or failing to sell) stock of the company in reliance upon projections made in a speech in February 1965 before the New York Society of Security Analysts. The speech, made by two of the directors, "with the consent and approval" of the third, estimated that the company's total income for the fiscal year ending June 30, 1965, would exceed $10,000,000, cash flow would approximate $6,000,000, and net income would be $3,500,000, or about double the income for the first six months of the year (subject to some reduction in case of acquisitions). The figures upon which these predictions were based had been prepared by the accountants; the public relations firm was employed by the company to distribute copies of the speech to shareholders and others. The plaintiffs claimed that the purpose of the speech and its distribution was to induce dealers to promote the sale of the stock, and to induce stockholders and others to retain or purchase shares. Plaintiffs charged that defendants "knowingly and intentionally, with intent to deceive," had failed to disclose in the speech that the accountants had underestimated the provision for depletion and depreciation for the first six months of fiscal 1965. Accordingly, the company's 1965 results were much lower than had been predicted, and the publication in late April 1965 of the nine-month's report showing the actual figures precipitated a drop in the market price of the stock.

The decision itself in *Sprayregen* deals only with procedural matters, its principal holding being that stating a case under Rule 10b-5 does not require an allegation that the defendants made the misleading statements in order to enhance their own positions in the securities market; it is enough that the statements might cause reasonable investors to rely and thereby purchase or sell securities. (The court was not sure that merely holding on to shares satisfied the apparent requirement of Rule 10b-5 that there be a purchase or sale but found that the plaintiffs' alternative claim of having purchased stock was sufficient to clear this hurdle.) The court also held that the director who did not actually participate in the speech was as subject to liability under Rule 10b-5 as those who did if it was shown that he consented to and approved of their actions.

On the merits of forecasting, the case is useful only as an example of the close relationship between projections of the future and the financial statements for the past (which necessarily include their own "estimation" component, such as here for depreciation and depletion). The case affords

no guidance as to negligence, since it was alleged that the defendants had acted "knowingly and intentionally."

Subjects for Further Reflection

First, a brief comment about the relatively small number of cases involving attacks on forecasts thus far. While this could mean that forecasts are not quite as inviting a target as suggested earlier, my own guess is that the paucity of cases is due to the fact that wide-scale forecasting is still a relatively recent phenomenon. For obvious reasons, litigation often lags the state of the art by several years; and, the fact that cases are already pending in connection with the forecasts for Bausch & Lomb and Wrigley, two of the better-known recent subjects of forecasts, may be a more accurate harbinger of things to come. The legion of cases involving over-optimistic predictions by brokers or other salesmen to potential buyers about the future of a stock, oftentimes interspersed with observations about future sales, net income, and the like, are not particularly relevant for our purposes. These cases have almost always included not only some specific factual misrepresentations, but also a lack of any sufficient basis for the predictions made (a lack which should not often characterize a management forecast); in addition, the broker cases also present the issue of justifiable "puffing" of goods offered for sale, see e.g., *Phillips* v. *Reynolds & Co.,* 294 F. Supp. 1249 (E.D. Pa. 1969), a defense to which the courts have displayed increasing hostility in the securities field of late, [see Loss, *Securities Regulation,* Vol. VI (1969 Supp.) 3541] but which would in any event scarcely be permissible in connection with management forecasts designed to inform and advise the investing community.

Second, reference has already been made to the fact that at the present time the SEC does not permit the inclusion of forecasts in registration material or in connection with proxy solicitations. The given reason, often expressed in SEC opinions, is that forecasts, particularly when reduced to specific dollar figures, give a false appearance of precision which makes them inherently misleading. (See, for example, *Thomas Bond, Inc.,* 5 SEC, 60, 1939.) Similarly, the SEC's Proxy Rule 14a-9, prohibiting false or misleading statements in proxy solicitations, gives as its first example of what may be misleading: "Predictions as to specific future market values, earnings or dividends." This rule was the subject of the following comment in *Union Pacific Railroad Co.* v. *Chicago & Northwestern Ry. Co.,* 226 F. Supp. 400, 408-409 (N.D. Ill. 1964), enjoining a shareholder vote on a choice between competing merger offers because of violations of the proxy rules:

> There is good reason for this emphasis on prediction. Bald statements contrary to concrete and historical fact run the risk of ready refutation and exposure, and to that degree are self-policing. Predictions, estimates, and opinions are more elusive and may present graver dangers of misleading the investing public. They lend themselves to this evil by allowing facts to be suggested or implied without direct statement. Even if they do not tend to induce

belief in any particular fact, they nonetheless import the existence of unspecified facts which support the conclusion. The shareholder may be led readily to assume, contrary to fact that the predictor has special knowledge or unique information to bear out fully his prediction, and be induced to rely upon a supposed expert judgment of the mysteries of finance. "Since an expert can speak with authority only as to subjects upon which he has professional knowledge and since no engineering course or other professional training has ever been known to qualify anyone as a clairvoyant, attempts by companies to predict future earnings on their own or on the authority of experts have almost invariably been held by the Commission to be misleading because they suggest to the investor a competence and authority which in fact does not exist." Heller, "Disclosure Requirements Under Federal Securities Regulations," XVI, *The Business Lawyer,* 300, 307 (1961). Whether the prediction is the product of an intent to mislead or of innocent overenthusiasm, the misleading effect upon the investing public is the same.

If these characterizations of forecasts were to be taken literally, then any forecast would seem to fall squarely within the prohibition of Rule 10b-5 against misleading statements, which in turn could lead to virtually absolute liability for any loss resulting from a forecast that proved inaccurate. On the other hand, it does not appear that such a theory has ever been advanced by the SEC or anyone else, and perhaps the basis for it will soon evaporate, in view of the SEC's current intensive reexamination of its position and Chairman Casey's recent speeches indicating a favorable disposition toward permitting the inclusion of forecasts in material filed with the Commission.[3]

At the opposite end of the Rule 10b-5 spectrum is the question of whether the Rule could be construed to impose an affirmative obligation on companies to publicly disclose their internal forecasting data. It was, after all, in imposing on corporate insiders the duty to disclose their special information when purchasing the company's stock that Rule 10b-5 first made its mark, before it became the general policeman of all misrepresentations. And of late there have been a number of developments in the direction of extending the disclosure obligation well beyond the case of insiders dealing with the company's stockholders, making it applicable to all information that would be relevant to the investing community at large—in other words, a kind of generalized obligation to the integrity of the securities markets. For example, the New York Stock Exchange's disclosure policy calls for a corporation "to release quickly to the public any news or information which might reasonably be expected to materially affect the market for securities."[4] To much the same effect is the now classic decision in this field, *SEC* v. *Texas Gulf Sulphur Co.,* 401 F. 2d 833, 860 (2d Cir. 1968), and under Judge Friendly's definition of "materiality"—any information which would prompt a

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[3] See footnote 1.

[4] New York Stock Exchange, "Company Manual A-18" (1968).

reasonable man to make an investment decision—there seems little doubt that a company's internal forecasting data could qualify.[5]

Of course, the primary objective of disclosure requirements is still to prevent unfair advantage to insiders, tippees, and the like (which incidentally means that unpublished internal forecasts not only must not be used by insiders but also must not be made available to a favored few stockholders or potential investors),[6] hence a showing that no such people were trading with knowledge of the undisclosed information would make the risk of liability under Rule 10b-5 for failure to publicize more theoretical than real. But this would provide little comfort in the case of internal projections, if they were found to be subject to the disclosure obligation, since they exist continuously, subject to constant review and revision, and the result would be to permanently bar insiders from trading in their company's stock. And this result would not be altered even if it could be shown that the decision not to disclose internal projections had been made to further the best interests of the company, because of the possible benefits to competitors from publication; such a contention might be accepted, as was the alleged business need to acquire adjoining lands in the *Texas Gulf Sulphur* case, but at the cost of excluding insiders from the market until the information was disclosed, which in the case of internal forecasts would mean permanently.

Professor Bromberg, in the article cited in note 5, contends that projections do indeed fall within the disclosure obligation, at least where they are for the short-term future and there is reasonable basis for confidence in them on the basis of previous experience or otherwise. Even so, he suggests that, except when current projections indicate a very significant variation from past performance, the risk of withholding projections may be less than the risk that releasing them will result in suit by investors who place undue reliance on them. (Perhaps this quite legitimate concern should instead be advanced against finding any obligation to disclose forecasts in the first place.)

Would there be any impact on this question of a possible disclosure obligation if the SEC reversed its stand and decided to allow forecasting in registration and proxy material? In theory perhaps not, since the present SEC strictures do not constitute a legal justification for failing to disclose (if any duty to do so were found) in contexts other than registration and proxy solicitation. But in practice this could help to support a disclosure obligation since it would at least eliminate the awkwardness of insisting upon disclosure of information that the SEC would not permit to be included for its purposes. Not that such inconsistencies have bothered the SEC much; in *Gerstle* v. *Gamble-Skogmo, Inc.*, 298 F. Supp. 66 (E.D. N.Y. 1969), the SEC contended that the estimated liquidating values of certain of a company's assets likely to be sold off should have been disclosed in the textual material (though not in the financial statements) in a proxy solicitation for approval of a merger,

[5] See, generally, Bromberg, "Disclosure Programs for Publicly Held Companies—A Practical Guide," *Duke Law Journal* (1970), p. 1139.

[6] SEC Litigation Release No. 4080, August 8, 1968.

although the SEC staff had rejected a suggestion that such information be included at the time of the filing of the proxy material with the Commission.

If a company does undertake to publish forecasts, whether voluntarily or pursuant to a disclosure obligation, it may then have the duty to continuously review the data and publish periodic revisions if called for. Just how often such revisions should be made is far from clear, but probably on some regular basis, plus immediately upon any significant and unexpected development (which of course might require disclosure even if the company were not publishing forecasts). Such an additional responsibility would create another level of potential claims for damages, quite independent of the merits of the forecasts actually made, and might well constitute a further objection from management's point of view to publishing forecasts in the first place. Compare *Financial Industrial Fund* v. *McDonnell Douglas Corporation,* CCH Fed. Sec. L. Rep. No. 93,004 (D. Colo. 1971) (defendants who had issued optimistic earnings reports were obligated to publicize deterioration in the company's condition).

Appendix

British Forecasting Practice

Because so much of our literature on forecasting makes reference to the British practice, it may be useful to summarize just what that is. In Great Britain there are three primary sources of so-called "profit forecasts":

1. In take-over bid circulars and merger proposals.
2. In the prospectuses issued in conjunction with an offering of securities.
3. In annual reports, Chairmen's statements, and the like.

Since most of the notoriety about the British experience relates to take-over bids, we might look there first. The starting point is the City Code on Take-overs and Mergers, a voluntary system of self-regulation adopted by representatives of leading institutions of the City of London as a guide to good business practices in the conduct of take-overs and mergers. While the City Code does not have the force of statute aw, it is very influential as a practical matter because breach of its provisions could result in public censure, or, in an extreme case, delisting of a company's securities from an exchange. The Code has been revised twice since its adoption in 1968, and in the latest version (the third edition of the Code), Rule 16 dealing with profit forecasts (Rule 15 in prior editions) provides as follows:

> Without in any way detracting from the imperative necessity of maintaining the highest standards of accuracy and fair presentation in all communications to shareholders in a take-over or merger transaction, attention is particularly drawn in this connection to profit forecasts . . . . Notwithstanding the obvious hazard attached to the forecasting or profits, any profit forecasts must be compiled with the greatest possible care by the directors, whose whole responsibilities they are. When profit forecasts appear in any document addressed

to shareholders in connection with an offer, the assumptions, including the commercial assumptions, upon which the directors have based their profit forecasts, must be stated in the document. The accounting bases and calculations for the forecasts must be examined and reported on by the auditors or consultant accountants. Any financial adviser mentioned in the document must also report on the forecasts. The accountants' report and, if there is an adviser, his report, must be contained in such document and be accompanied by a statement that the accountants, and, where relevant, the adviser, have given and not withdrawn their consent to publication. Wherever profit forecasts appear in relation to a period in which trading has already commenced, the latest unaudited profit figures which are available in respect of the expired portion of that trading period together with comparable figures for the preceding year must be stated. Alternatively, if no figures are available, that fact must be stated.

The Panel on Take-overs and Mergers, which administers and enforces the City Code, has issued interpretations, called "Practice Notes," in connection with this Rule. Practice Note No. 4 (revised edition, February 16, 1972) deals with the question of what constitutes a profit forecast for the purpose of the Rule, in the following terms:

> It is impossible to generalize but broadly whenever a form of words puts a floor under (or, in certain circumstances, a ceiling on) the likely profits of a particular period or whenever a form of words contains the data necessary to ascertain an approximate figure for future profits by an arithmetical process, the Panel takes the view that there is a profit forecast. . . .

Practice Note No. 6 (revised edition, February 16, 1972) is a good deal more extensive, dealing with the assumptions on which a forecast is based. The Practice Note calls for listing the assumptions, together with information that would help shareholders reach their own decision as to the reasonableness and reliability of the forecast, and then adds, "This should include a summary of the conclusions reached by the directors on matters which required judgment as to the likely outcome of events, and should draw the shareholders' attention to, and where possible quantify, those uncertain factors which could materially disturb the ultimate achievement of the forecast." Practice Note No. 6 goes on to suggest that some indication be included as to how the profit forecast would be affected if certain of the major assumptions prove to be ill-founded: "For example, the effect might be shown if sales volume, selling prices, raw material costs, etc., were *Y*% above/below estimate, or if full production from a new factory were delayed by *Z* months. It may be appropriate for maximum and minimum forecast profits to be given rather than a single figure."

While profit forecasts are not required by the City Code, they are very likely used in take-over situations, on behalf of both the offeree company

and the offeror. Since May 1, 1969, the Panel on Take-overs and Mergers has been actively policing profit forecasts in these situations by keeping records of the forecasts made and comparing them with the actual results. In its Report for the year ending March 31, 1972, the Panel stated that of the 210 cases of forecasting which had been checked, 170 had proved to be accurate within 10 percent. The Panel undertook to investigate the 40 cases in which the forecasts had not been that accurate, and of the 19 cases where the investigation had been completed there were only 3 where there was no satisfactory explanation (such as unforeseeable developments, reflecting no discredit on those who had been responsible for making or reporting on the forecasts).

With regard to the role of accountants and other advisers in profit forecasts, the original version of Rule 16 (Rule 15 at that time) required that "the calculations and the bases for the forecasts must be examined and reported on by the auditors or consultant accountants." However, the report by the accountants was to go only to the directors; it was not expected that their report would be made public (except perhaps if it took strenuous issue with the forecast made), and the Council of the Institute of Chartered Accountants promulgated guidelines on the proper role of accountants, stressing that "the name of the reporting accountants is not to be directly associated with the profit forecasts."[7] In the 1969 revision of the City Code, Rule 16 was amended to change the subject of the accountants' examination and report into its present, narrower form: "the *accounting* bases and calculations for the forecasts." (Emphasis supplied.) In this same revision the accountants' report was required to be made public as part of the document addressed to stockholders concerning a take-over offer and containing the forecast; but, perhaps as a corollary, language was added making clear that the forecasts were the "sole responsibility" of the directors (subsequently changed to the present awkward phrase, "whose whole responsibilities they are," in the third edition of the City Code).

The role of the "financial adviser" under Rule 16 has had a somewhat similar history. The original version of the Rule required that "the forecasts and the assumptions on which they rest must be corroborated, as far as possible, and reported on by the company's merchant bank or other advisers." In the 1969 revision this was softened to require only that "any Merchant Bank or other adviser maintained in the document must also report on the forecasts," but any such report had to be included in the document to the stockholders; and in the third edition of the Code the phrase "any Merchant Bank or other adviser" was collapsed into the present simple "any financial adviser."

Incidentally, it might be noted that the April 1969 revision of Rule 16 to require that the reports of the accountants and financial adviser be made public by way of inclusion in the document to stockholders coincides with the date when the Panel on Take-overs and Mergers launched its program of

[7] See Statement by the Council of ICA, "Accountants' Reports on Profit Forecasts," *The Accountant* (July 27, 1968), pp. 123, 125.

carefully checking the record of forecasts against the actual events. The Director-General of the Panel in a 1971 article strongly implied that this "requirement for accountant and merchant bankers to stick their names on to the profit forecasts on a take-over bid" may have been responsible for the fact that in the "two years plan of policing, we have in fact been rather pleased with the results," whereas before this policing of forecasts began in 1969 "the record was poor."[8]

The other major occasion for dissemination of a profit forecast in England is the issuance of a prospectus in connection with a public offering of securities (the very situation, it may be recalled, where forecasts are least likely to appear under our practice, because of the SEC's current refusal to permit their inclusion). Although in theory such prospectuses are subject to the basic English corporation legislation, the Companies Act of 1948, in practice they are governed by the self-regulation of the Federation of Stock Exchanges, because the Companies Act exempts offerings made through a member of the stock exchange in compliance with the rules of the exchange (and since there is virtually no over-the-counter market in England, most offerings are made pursuant to the exchange requirements). The Rules of the Federation of Stock Exchanges relating to "Admission of Securities to Quotations" (which appear in a book with a canary-yellow cover, sometimes referred to as the "Yellow Peril") contains a section entitled "Contents of a Prospectus" (Schedule II, Part A), which requires "a statement as to the financial and trading prospects of the Company." Though this is hardly a clear-cut requirement of profit forecasts, the general practice in England, according to a 1972 article by John Grieves, a London solicitor (publication whereabouts unknown), is for the prospectus to contain forecasts with regard to the profits of the financial year in which the prospectus is issued (commonly accompanied by a statement as to the dividend expected to be recommended). A typical form of language as to expected profits might be as follows: "The Directors expected that, in the absence of unforeseen circumstances, the pre-tax profits of the Company for the financial year ending 30th June 1972 will not be less than £350,000."

It should be noted here that profit forecasts in prospectuses are customarily quite conservative, and it is unusual for these forecasts not to be met. According to the Director-General of the Panel on Take-over and Mergers, in the article cited above, the reason for this is that a company will get a much better market rating over the long run if its original market flotation was done on a somewhat conservative basis, whereas "no harm is done to the old shareholders if the forecast is exceeded, even by a large amount [since their] benefit accrues in the enhanced market value of the shares which they have retained." He contrasts this with take-overs, where "both the attack and the defense tend to overestimate," but where, conversely, undue conservatism could do a real disservice to a company's own

[8] Fraser, "Accounting and the Merger Movement," *The Accountant* (September 9, 1971), pp. 353, 355.

stockholders in terms of reflecting the real values they would be contributing to the proposed combination.

Finally, as to profit forecasts in annual reports and the like, directors are not normally anxious to commit themselves to an estimate of the profit or loss for the current year, and hence do not do so unless there is some special occasion for it. And when forecasts are included in the annual report, according to Grieves, in the article noted earlier, they are "customarily couched in vague and general terms and hedged with broad qualifications"; hence, he concludes that forecasts in annual reports do not have the significance of forecasts in prospectuses or take-over bids.

Turning now to the question of possible liability for mistaken forecasts, as to take-over bids, it has already been noted that the City Code does not have the force of law; hence the language of Rule 16 calling for the compilation of profit forecasts "with the greatest possible care by the directors, whose whole responsibilities they are" must be regarded as principally hortatory in nature (subject to the extra-legal sanctions referred to above). Therefore, any liability on the directors in these circumstances would have to be predicated either on particular statutory provisions or general legal principles. Great Britain has no Rule 10b-5, but it does have a Prevention of Fraud (Investments) Act of 1958, which, in section 13, provides that "any person who, by any . . . forecast which he knows to be misleading, false or deceptive, . . . or by the reckless making (dishonestly or otherwise) of any . . . forecast which is misleading, false or deceptive" induces or attempts to induce another person to buy or sell securities shall be guilty of a crime. Obviously, a knowing or reckless exaggeration of estimated profits, as might occur in a take-over bid (or in a prospectus for that matter, although, as noted, under current practice, that is far less likely), would run afoul of this statute as to whether an action for damages would lie, that would depend on whether the English courts find that this statute gives rise to implied civil liability for violations (the theory on which civil actions are brought under Rule 10b-5 in this country).

What about liability for negligent error in a forecast? There may be more risk of such liability for a forecast in a prospectus than in other situations, because of section 43 of the Companies Act, which imposes civil liability for misstatements in a prospectus unless the defendants had reasonable ground to believe the statement was true, an approach quite reminiscent of our section 11 of the Securities Act. Apart from that provision, liability for negligence would have to be based upon common-law principles. Grieves suggests that, whatever might be the case with stockholders who act pursuant to a prospectus or a take-over bid, "it is unlikely that a person who purchased securities in the market in the ordinary way, on the strength of a profit forecast made by a company, would have any remedy." This sounds like an application of the privity doctrine, which may still have force in England although it seems to be evaporating here. In any event, Grieves notes that "civil actions based upon profit forecasts not being met have been conspicuous by their absence." But this probably says more about the still rudimentary state of stockholder's suits in England than it does about liability

for forecasts. There are several differences between the English practice and ours that account for the lag in the development of stockholder's suits there: particularly, (1) the fact that contingent fees, which have proved such a strong inducement to shareholder's suits here, are shunned by English lawyers; and (2) that under the English approach an unsuccessful plaintiff might be required to pay the defendants' legal expenses, rather than merely costs as is the custom here. Obviously, therefore, as a practical matter the English forecasting practice was able to be developed with a good deal less concern about liability than would be true here, especially today.

As to possible accountants' liability in connection with forecasts, that depends, as it would in this country also, on just what role the accountants play. In take-over bids, Rule 16 of the City Code makes the forecast and the underlying assumption the responsibility of the directors; while accountants are required to report on the "accounting bases and calculations," it is assumed that they do not have any responsibility for the figures. The Statement of Guidance of the Council of the ICA, "Accountants' Report on Profit Forecasts" (*The Accountant,* May, 1969) seeks to confirm this, noting that profit forecasts are not capable of confirmation and verification by reporting accountants in the same way as financial statements for past periods, and that there is no question of their being "audited." The Statement of Guidance continues as follows:

> It is important that reporting accountants . . . in the wording of their report . . . should take care to avoid giving any impression that they are in any way confirming, underwriting, guaranteeing, or otherwise accepting responsibility for the ultimate accuracy and realization of forecasts. . . . Reporting accountants can however, within limits [discussed in the Statement], properly undertake a critical and objective review of the accounting bases and calculations for profit forecasts, and can verify that the forecasts have been properly computed from the underlying assumptions and data and are presented on a consistent basis.

Presumably, if accountants were negligent in their discharge of this function, they could be liable to stockholders who had acted on the tender offer to their loss (since the stockholder recipients of the tender offer would seem to be squarely within the group whose reliance on the accountants' report was clearly foreseeable).

In addition, Practice Note No. 6, "The Assumptions on Which a Profit Forecast is Based" (one of the memoranda "of interpretation and practice" under Rule 16 of the City Code, promulgated by the Panel on Take-overs and Mergers) observes that accountants and financial advisers have substantial influence on the information given about assumptions, and adds, "Neither should allow an assumption to be published which appears to them unrealistic (or one to be omitted which appears to them to be important) without commenting on it in their reports." However, the nature of the responsibility imposed by this statement seems somewhat more removed from the normal accounting function than, say, "accounting bases and calcula-

tions," and to that extent liability for negligence in discharging this responsibility might well be less likely.

It may be worth noting that in investigating cases of badly missed forecasts the Panel on Take-overs and Mergers asks the company's accountants and other financial advisers for a formal written explanation of how the forecasts went so wrong. A novel feature of such inquires, by the way, is that the Panel has itself employed leading firms of chartered accountants to act as consultants in considering the explanations given.

Turning to forecasts in prospectuses, it does not appear that accountants play any part in the process. The Stock Exchange rules governing the contents of a prospectus, which deal extensively with the required report by the auditors with respect to the company's profit or losses for the previous ten years, its assets and liabilities, and "such other matters which appear to the auditors to be relevant," do not seem to call for any comment on profit forecasts. Nevertheless, according to an article by Metz in the *New York Times* on February 24, 1972, on the English practice, accountants are unwilling to put their names on a document if the projection is out of line.